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Understanding DIVERSIFICATION & RISK

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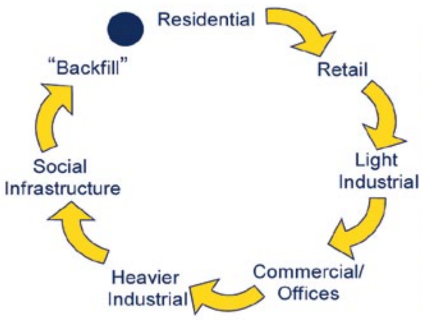
Although property and equities may, over a long period of time, produce similar returns, it is important to appreciate that nonetheless they behave very differently along the way for a variety of reasons. For example, during the GFC, property in direct ownership with managed debt performed far better than equities that had too much imbedded debt. For this reason, direct investment in property can improve the diversification of a portfolio of assets allowing for stronger performing assets to support those assets experiencing weaker conditions. Another good reason for diversification into directly owned real estate is that it involves a long-term commitment and is a disciplined investment strategy, not easily changed, and therefore not vulnerable to fluctuating sentiment on a daily basis like equities. Diversification to include such a long term committed approach, balances what might be short term strategy investments. Diversification into direct property can therefore reduce risk and smooth returns, but what are the areas of relative risk?

Development Progression / Relative Risk



This chart demonstrates that development begins and is sustained by a residential nucleus, which as the lowest risk real estate, determines the subsequent sub-markets, which establish in the order of progression demonstrated. As the cycle evolves, each subsequent category relies upon the vibrancy of the preceding markets in consequence of which the risk increases progressively.

It is emphasised that residential real estate is the lowest risk category, being at the lowest price point, very liquid, and required by everybody, not just investors. It is the easiest real estate category within which to invest, borrow, and have some flexibility and it is strongly recommended should form the solid core of any property portfolio.

Indeed, several million dollars can sensibly be committed to this classification over the medium to longer term before there need be any thought about moving to other property classes. When diversification moves in the direction of non-residential, retail is the next least risky category, as it suffers little from obsolescence or locational trends but rather tends to consolidate longer term to become better quality. In contrast, commercial office, and particularly industrial real estate, is much more affected by locational trends and building obsolescence. For this reason, shrewd investors realise that with industrial and commercial property the higher risk requires faster amortisation of their investment for which reason property yields in these classes will always be higher than retail yields, which because of lower risk does not require as fast amortisation of the investment capital. Unlike cash which offers only interest and no capital growth, real estate, as with equities, offers both income and capital growth, which analysed on an annual basis is referred to as the "internal rate of return (IRR)". With real estate, the proportion of return from income versus capital growth does vary, and whilst the combination of both don't exactly equate to the analysed IRR, they can for simplicity, be summarised using the following apportionment as a guide to differentiation between the four main property classes.

Simple Comparison of Relative Investment Returns

Simple Comparison of Relative Investment Returns		
	Annual IRR	**Comments**
Cash	6.5% p.a.	Cash only
Prime Real Estate	9% - 10%	Less Income/More Capital Growth
Secondary Real Estate	12%	Higher Income/Less Capital Growth
Prime Equities	12%	Income and Capital Growth
Active Development Investments (Construction/Subdivision)	18% - 22%	All Income Returns/No Capital Growth

The above summary is very simplistic, and only indicative for the purpose of differentiation, highlighting for example that residential investments are more orientated towards capital growth than income return, but that at the other extreme, industrial properties rely more on income return rather than capital growth. This concept of "IRR", is a frequently adopted measure of analysis, and for passive investment properties, as the table indicates, varies in the range 9% – 12%, although for active development investments, such as construction or subdivision, increases commensurately with the higher risk, often up to 18% – 22%. To complete the comparison, the following chart, although again very simplistic, is indicative of the relative overall return, from a broad range of assets.

Apportionment of Investment Return

Apportionment of Investment Return (Before Tax)			
	Annual Net Income Return	Annual Capital Growth	IRR
Residential	3%	6%	9%
Retail	5%	5%	10%
Commercial Office	8%	3%	11%
Industrial	9%	3%	12%

In Australia, particularly its capital, and especially Melbourne, the medium to longer term investment prospects are very good. This is due essentially to strong population growth, which, notwithstanding the diversity of views and Government Policy from time to time, is assured to remain strong. Returning to the first chart in this article, strong population growth not only creates residential housing demand, but drives the subsequent retail, industrial and commercial office markets. Our research has determined that a new dwelling is required for every two new heads of population, and that in the non-residential sector, every new head of population growth generates a need for 1.5 square metres (sq.m.) of retail accommodation, 2.1 sq.m. of office accommodation, and up to 18 – 20 sq.m. of various industrial, warehouse, factory, logistic and high-tech accommodation. Unlike many countries overseas, all of these classifications, due to the lack of construction during the GFC period, are at very low vacancy levels and so there are excellent prospects within all these categories, subject to careful choice, for strong rental growth and capital performance during the next decade. A broad study of population growth and trends recognising preferred growth areas and the effects of demographic change assists selection of a good investment property and is available through appropriate consultants.